**STATEMENT BY**
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**BEFORE THE**
**COMMITTEE ON ENERGY AND NATURAL RESOURCES**
**UNITED STATES SENATE**

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Mr. Chairman and Members of the Committee:

I appreciate the opportunity you have afforded me to discuss the electricity pricing abnormalities that occurred in the Midwest during the week of June 22-26, 1998. This is a topic of great national importance as we move toward electric competition because, in the minds of some, events in the Midwest have raised doubts about the preparedness of utilities, other market participants, and regulatory agencies to manage this transition to competition in a manner that protects and serves the best interests of consumers. I therefore applaud your foresight in convening this hearing to examine these developments and their significance.

Today I am privileged to present to the Committee and the public a Federal Energy Regulatory Commission (Commission) staff report that analyzes what happened in June and why it happened. The staff report also suggests areas that regulators and the electric industry should study further to help prevent such market abnormalities in the future. This report is the result of eight weeks of information gathering and study by a seven-member, interdisciplinary team of Commission technical and legal staff.

In sum, the pricing abnormalities in June involved prices for wholesale power bought and sold on an hourly basis in what is known as the “spot market”. These dramatic price increases from the $25 per megawatt hour (MWh) range to as much as $7,500 per MWh on June 25, occurred during a period of very hot weather when electricity usage was high and storms had damaged power lines and generating stations. However, despite these temporary wholesale price increases, neither the reliability of the transmission grid nor firm service to consumers was compromised.

Although the particular combination of factors that led to the June wholesale price increases is unlikely to recur, neither the staff team nor I underestimate the possibility that pricing abnormalities may occur in the future. June's events in the Midwest underscore the need for the Commission, state regulators, and the power industry to maintain open communications, to collaborate where appropriate, and take whatever steps they can, on an ongoing basis, to ensure that power markets function efficiently, fairly, and effectively and that sufficient generation and transmission resources are available where needed. This applies not only to the Midwest but to all regions of the country as we move forward in the development of competitive power markets.

## I. The Genesis of the Staff Report

On June 25 and 26, 1998, the wholesale price of electricity in the Midwest increased dramatically. Hourly prices for electric energy rose from the $25 per MWh range to as much as $7,500 per MWh on June 25. This prompted several utilities and power marketers to ask the Commission to hold an emergency conference on the cause of price increases. Some asked the Commission to "cap" wholesale electric prices, to arrest the ability of some market participants to charge market rates, or to take other drastic actions to restore "normalcy" to the market. Others urged regulatory restraint and argued that there was no need to rein in the activity occurring in this burgeoning electric market, in which hundreds of marketers and traders now compete across the country in part as a result of open access transmission under the Commission's Order Nos. 888 and 889.

In response to these price increases, I asked my managers to create an interdisciplinary team of Commission staff to study the questions posed by developments in the Midwest. (In the interest of fairness and obtaining information from market participants, I will not permit these staff persons to participate in any contested Commission case arising from this set of facts.) The team was asked to determine how and why the price increases happened, and whether similar events are likely to recur. The principal purpose of the requested study was to provide information about what happened. This information will help the Commission make informed decisions on whether any corrective measures or new initiatives are needed as wholesale power markets move from cost-based regulation to competition. The Commission also convened a conference with state regulators in Chicago, Illinois, on August 14 to discuss these issues among ourselves and with diverse industry representatives. The Commission purposefully did not attempt to adopt regulatory remedies immediately for fear of further jeopardizing market stability. In light of the tendency of Midwest prices to moderate after the events of late June, that judgment appears to have been appropriate.

The study team members worked for eight weeks to gather and analyze information. They interviewed representatives of traditional investor-owned utilities, power marketers, municipal utilities, rural electric cooperatives, and the Pennsylvania-New Jersey-Maryland Interconnection (PJM). These entities are buyers and sellers in the Midwest wholesale power markets. They include owners, operators, and users of the transmission system. The team also spoke with representatives of state regulatory commissions, Federal agencies, the North American Electric Reliability Council (NERC), and regional reliability councils. To ensure frank responses, the identities of responding parties have been purposely withheld by the team.

The team members asked a broad range of transmission providers and marketers for data on their electric energy purchases and sales during the week of the abnormal price increases. The prompt responses from the utilities and marketers under the Commission's jurisdiction, as well as from a number of non-jurisdictional entities (such as municipal sellers, cooperatives, and Federal agencies), greatly aided the team's inquiry.

**II. The Findings of the Staff Report**

The information gathered by the team confirmed that the June pricing abnormalities, often called the “price spike," was an extraordinarily high but relatively short-lived increase in wholesale spot market prices. Some load-serving utilities paid very high hourly prices for some of the electric energy. Those prices lasted only hours before returning to more common levels, however. Subsequent to the June price spike, except for a smaller flare-up in July, Midwest wholesale electricity prices stabilized.

As discussed below, the team found that a combination of factors led to the June pricing abnormalities. Some of the contributing factors were linked to long-term trends in the Midwest. Other factors were short-term phenomena in that market area. However, as discussed below, the particular combination of factors that led to price increases of such magnitude was quite unusual and therefore not likely to recur. In addition, while the price increases significantly raised wholesale energy costs for some Midwest utilities, the market participants protected the reliability of the regional transmission system and widespread losses of power were not experienced. The team did not find evidence that firm service to consumers was compromised anywhere in the Midwest during the period of the pricing abnormalities.

**A. Long-term factors.**

Staff unearthed some important long-term issues that, if left unaddressed by Midwest market participants, could have disturbing consequences. The Midwest summer peak demand for electricity has grown substantially. Additions of new generating capacity have not kept pace with this increased demand. In addition, as was the case in the summer of 1997, substantial amounts of nuclear baseload generation were out of service in the Midwest in June 1998. A substantial portion of this lost generation was attributable to planned, as opposed to unscheduled, outages. These factors are causing Midwest utilities to depend more and more on purchases of power from other regions to meet peak demands.

**B. Short-term factors.**

Among the immediate and precipitating factors that led to problems in June, weather played a key role. A stretch of unseasonably hot weather sent temperatures well above forecasted levels throughout much of the Midwest and neighboring regions in late June, pushing electric loads to near-record levels. In addition, powerful storms damaged transmission lines and shut down certain generating facilities, further reducing available generating and transmission capacity just before weather-related demand peaked. Because the higher-than-forecasted temperatures and storm damage affected a large area, many utilities and other sellers who normally would have sold electric energy to Midwest utilities were themselves confronted by high demand. Transmission constraints also hindered the movement of power from the East to Midwest markets.

The study team also concluded that the default by several wholesale marketers on contracts to sell electric energy substantially increased uncertainty in the market about whether buyers could find enough electricity as demand increased. Market participants scrambled to secure power so that they would be able to meet their contractual commitments if called upon to do so. It appears to staff that market participants reacted in a variety of ways to these unprecedented events. The psychology of the market during the stresses that prevailed was not (and perhaps still is not) especially well understood. Some utilities were willing to pay very high prices in the spot market to ensure reliability and to fulfill their service franchise obligations to their native load customers. Such purchases were usually for periods of short duration. Nevertheless, as perceived demand for power increased and as supply became more difficult to find, wholesale prices went up unexpectedly and dramatically.

While there were allegations of market manipulation, the focus of the report is principally on overall market conditions. During its eight-week information gathering effort, the team was unable to conclude that the regional pricing abnormalities were attributable in any measurable way to misconduct, self-dealing, or manipulation. However, I want to assure the Committee that, if information concerning violations of Federal law comes to the attention of the Commission, the Commission will diligently pursue it through its normal compliance and enforcement functions.

**C. Future Actions.**

While the team concluded that the combination of factors leading to the June price increases was unusual and not representative of how Midwestern wholesale electricity markets usually function, it nevertheless recommends that the electric industry and regulators take full notice and account of the events and developments that gave rise to the pricing abnormalities and plan accordingly. The staff team has chosen to identify issues toward which we might direct our attention in the future. It believes that as buyers and sellers gain experience in competitive wholesale power markets, they will develop ways to acceptably manage their exposure to the risk that severe operational conditions could lead to dramatic increases in the price of bulk power at certain times. Based on the factors contributing to June's problems, the team does not recommend that the Commission impose price caps on sellers with market-based rate authorization. Nor does the staff believe that the facts require the Commission to exclude certain market participants, for example by requiring power marketers to meet standards of creditworthiness. In sum, staff's findings have not led the team to encourage the Commission to do anything that might interfere unduly with the operation of the competitive market.

The report suggests that the Commission seriously examine key issues, particularly long-term policy issues. The team suggests that the Commission and its staff take the following steps:

* Maintain open communications with state policymakers who have jurisdiction over transmission and generation siting, NERC (which currently establishes reliability rules for the industry), and other entities, with respect to how our respective authorities or organizations can collaborate to ensure efficiently functioning power markets.

* Re-examine the Commission's monitoring activity to access whether new competitive markets are functioning properly.

* Formalize the Commission's working relationships and data-sharing arrangements with NERC and the network of control area operators and security coordinators.

* Review how to maximize compliance with Order Nos. 888 and 889 and prevent or redress attempts to manipulate the market or circumvent the Commission's restructuring of wholesale electric markets.

* Consider development of real-time reporting of the prices for and availability of wholesale power and interstate transmission.

* Promote the growth of regional entities that would independently operate transmission systems and plan and coordinate transmission.

## III. My Observations

The team's report and thoughtful analysis has now been presented to the Commission for its consideration. I, as well as my colleagues, will need time to digest the full implications of the report. I would like to take this opportunity to provide some preliminary observations.

I agree with the staff report that electricity regulation at the Commission will require enhanced market monitoring capabilities. However, market monitoring must be coupled with the development and enhancement of market institutions that support a competitive marketplace. I believe the Commission, other regulators, and the industry have a responsibility to be proactive in making markets work more fairly and efficiently. The need for care and vigilance is important not only for the Midwest region but for all areas of the country.

Some have suggested that the Commission should step in and protect wholesale customers from credit risks or price changes. As a general proposition, I do not believe that the Commission should adopt piecemeal measures that could skew the normal risk management decisions being made by market participants through specific negotiated contract provisions. Creditworthiness and the legitimacy of trading practices are important. However, in the wholesale market where participants tend to be large, well-financed, and sophisticated in dealing with one another, no one is more capable of developing risk management tools and other trading practices that minimize exposure to price swings than those participants themselves. Thus, I believe the Commission was correct in not precipitously imposing price caps to solve market abnormalities in June.

We need to recognize that the number of bulk power market participants and wholesale transactions have multiplied dramatically as a result of competition. For example, we now have more than 400 wholesale power marketers. Given this important dynamic, both regulators and market participants are just learning how to ensure that markets function smoothly and support vigorous competition. Unless there are compelling circumstances, we should minimize our interference in the operation of a competitive, fair, and properly structured marketplace. That is the bottom line but it also suggests the main question: how do we assure ourselves of such a marketplace?

If we are to avoid the type of price abnormalities that occurred in the Midwest, I do not believe that regulators should stand idly by. The Commission defines as one of its overarching missions the promotion of competitive markets as part of its obligation to serve and protect the energy-consuming public. I hope that notion becomes bred in the bone. Order Nos. 888 and 889, now over two years old, have been positive contributions to that effort. Some of the forces that drove June's pricing abnormalities were exacerbated by the continued balkanization of transmission planning and system operations. To cure such problems, regulators need to promote institutional changes that support fair and efficient markets on a generic basis. I am committed to taking steps within the Commission's jurisdiction to ensure non-discrimination in the transmission of power to buyers who value it most and fair generation trading practices. Key to this task is greater transparency with respect to transmission availability and pricing, generation pricing information, and real-time information sharing.  It is increasingly clear that the structural separation of control of the Nation's transmission grid generation will be essential to this task in the long run.

Independent transmission operators (ISOs) or other regional independent transmission institutions, in particular, can assist immeasurably in addressing many potential market problems. First, they can operate the transmission grid to ensure that monopoly transmission owners do not discriminate in favor of their own generation over another seller's generation.  Second, they can eliminate pancaked transmission rates which some customers have to pay if they want to move power across one or more utility systems.  Third, they can better manage transmission congestion, reduce the need for line loading relief procedures, and effectively solve short-term reliability problems.  I believe the Commission's strong encouragement of ISOs and other independent regional transmission institutions is the key to solving a variety of complex market issues in ways that take account of state and regional preferences and conditions.  These institutions can help prevent the type of pricing abnormalities that occurred in June.

I would emphasize, however, that state regulators and other entities such as NERC play an important part in preventing extreme market dislocations. For example, states control whether and where new generation facilities and transmission lines are built through their statutory siting authority. Similarly, NERC and the regional reliability councils establish reliability rules for the industry. Thus, we all need to work together to use our respective authorities and organizations to ensure that power markets function efficiently.

## IV. Conclusion

We have learned important lessons from what occurred in the Midwest bulk power market this summer. These events underscore the need for vigilance by the Commission, state regulators, and industry groups in nurturing these newly competitive markets. I am committed, as I believe are my colleagues at the Commission, to doing what is necessary and appropriate, to move the industry forward in the development of competitive bulk power markets. I continue to have great confidence in the ability of competitive markets to benefit the American consumer and the economy.

Thank you again for the opportunity to appear before you today. I will be happy to answer any questions you have.